Does quality show through?

A rating system for emerging companies aims to sort the best from the rest

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Mining industry investors and companies are prone to grumble that equity markets fail to reflect a job well done. It happens often enough to make the question worth asking: does quality show through?

With about 1,000 listed resources companies in Australia, investors are continually challenged to discern what drives share prices. The biggest gains are usually attributable to unanticipated exploration success. The 8,000% gain in share price experienced by Sirius Resources NL over the eight months to last March is the stereotypical example.

Being catapulted overnight from capital market wallflower to belle of the ball is rare. Another 900 or so stocks must battle for attention based on more nuanced signs of progress that are a mystery to the vast bulk of the investing community who, by and large, are thankful for any excuse to ignore their activities.

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In early 2013, EIM Capital Managers decided to broaden its investment product offering by rating stocks in the resources sector for those investors seeking to manage their own portfolios. The new product called PortfolioDirect would offer investors, whether retail or institutional, a way to match their own risk appetites with the risk profiles of individual stocks.

Ultimately, with all stocks in the sector potentially receiving a rating there would be a basis for comparison shopping. Coverage would not rely on the prospects for a capital raising or brokerage commission, as it so often does at the moment. Companies, too, might benefit by understanding where they were in the pecking order and what they might have to do to enhance their standing.

There are some reasons to be nervous about the approach. Short-term disconnects between ratings and share price performance could easily arise. In more buoyant market conditions, for example, after the best credentialed companies have performed well, investors are known to search for market laggards. They buy stocks irrespective of their quality simply because their share prices have risen less than the prices of other companies.

Similarly, in dictating the level of prices, macro conditions appear at times to lead to indiscriminate buying or selling. The overwhelming majority of stocks have suffered large share price falls in the past two years with market liquidity often playing a role that overshadows corporate quality in importance.

Occasional market fads can also ignore quality differences. At times, stocks with uranium exposure, for example, have moved in the same direction because of views about the future use of nuclear power seemingly without much regard to where materials will be sourced. Investors have experienced similar rides with graphite stocks and rare-earth materials in recent years. It has happened to companies with coal or iron ore exposures at other times.

Against this backdrop, worrying about quality could easily be construed as an overly adventurous act of faith or even a waste of time.

Since the beginning of July, PortfolioDirect has formally reviewed and published ratings for 100 companies. Companies are categorised according to where along the development path from exploration to production they sit. Within each category, the stock is scored on a one to five scale with the 'best' being given a score of five and the 'worst' being given a score of one. Just over one quarter of the companies reviewed have received ratings of four or five. 51% have been given scores of one or two.

The ratings are prepared using explicit criteria. For an exploration company, the criteria boil down to an assessment of the likelihood of a company coming up with an unanticipated discovery within a reasonable period of time. Where a resource has been defined, the emphasis changes to whether the company will be able to come up with a viable development plan.

Having made a commitment to develop a project, a company will be judged on whether it has positive value momentum. A high rating depends on a rising value profile without having to rely on higher commodity prices.

The emphasis is on companies achieving goals. The approach measures the quality of assets and the capacity of the people in charge to get the best from them. The investment horizon is also of critical importance. Some resources may become mines in eight or 10 years. This is far too long for investment markets in which opportunity costs need to be taken into account. The emphasis is on making demonstrable and meaningful gains within 12-18 months to get the highest possible ratings.

Among the top-rated stocks in January, advances beat declines by more than two to one. Among the lowest rated stocks, there were more declines than advances. The average share price gain in January among the top-rated stocks was 36%. The lowest-rated stocks had an average decline of 9%. Category four and five stocks had higher median and average returns than the stocks in any of the other rating categories.

Over the longer haul, a similar profile is evident. Measured from the date of the rating, average and median stock returns in the top-ranked stocks have beaten those in each bracket of lower-ranked companies. The difference in average performance between the top-ranked and lowest-ranked categories was 34 percentage points over an average period since a rating was published of 117 days.

As always, past performance should not be taken as a guide to what happens in the future. These results might be a feature of relatively flat markets. In rapidly rising or falling markets (ie most of the time), the apparent good sense displayed here could be turned on its head. Time will tell. Measures of quality can also be highly subjective. Someone else's measures might fare less well or do better in different market conditions.

The results so far are not enough to prove anything conclusively. They do, however, offer jaded investors and frustrated company executives some comfort that quality can permeate the noise often enough to make it a worthwhile investment guidepost. ▼

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